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In the Supreme Court of the United States

OCTOBER TERM, 1956.

No. 265

ROSE PEDONE,
Executrix of the Estate of Sam Pedone,
and
ROSE PEDONE,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

CHARLES PEDONE and MARIAN PEDONE,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Claims.

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To the United States Court of Claims.

Petitioners pray that a writ of certiorari issue to review the judgments of the United States Court of Claims, entered in the above entitled cases on May 8, 1957, which cases involve identical questions (Rule 23(5)).

CITATIONS TO OPINION BELOW.

The opinion of the United States Court of Claims (R. 53), printed in Appendix A, *infra*, p. 9, has not yet been reported.

JURISDICTION.

The judgments of the United States Court of Claims were entered on May 8, 1957. (R. 77; p. 40, *infra*.) The jurisdiction of this Court is invoked under 28 U. S. C. Section 1255(1).

QUESTIONS PRESENTED.

A partnership of which petitioners were the members was engaged in selling plastering services as a plastering contractor. It made payments of wages to its employees who performed the services the partnership had contracted to sell. Some of these payments contravened the Defense Production Act of 1950, as amended, and the orders and regulations promulgated thereunder. The Commissioner of Internal Revenue, in assessing income tax deficiencies, disallowed the offset of a portion of the partnership's wage payments against its gross receipts.

The questions presented are:

1. Whether the partnership was entitled to offset against its gross receipts as a part of its cost of goods sold these wage payments made to its employees who performed the services the partnership had contracted to perform.

2. Whether the provisions of the Defense Production Act of 1950, as amended, disallow the offset of the cost of goods sold by a business against its gross receipts, where the goods sold consist of services and the cost thereof is the wages paid to employees who performed such services.

3. If the provisions of the Defense Production Act of 1950, as amended, permit such disallowance, whether said Act is void and unconstitutional because the tax that results is a tax on capital and not a tax on income within the Sixteenth Amendment to the Constitution of the

United States, and, therefore, violates Article I, Section 9, of the Constitution, which provides that a direct tax must be apportioned according to population.

CONSTITUTIONAL PROVISIONS, STATUTES, AND REGULATIONS INVOLVED.

The Constitutional provisions, statutes, and regulations involved in the cases are as follows:

United States Constitution, Sixteenth Amendment;

United States Constitution, Article I, Section 9;

Defense Production Act of 1950, 64 Stat. 798, as amended, 50 U. S. C. App. Sections 2061 *et seq.* (1952);

Internal Revenue Code of 1939, Sections 22(a) and 23(a)(1), 26 U. S. C. 1952 ed.; Sections 22(a) and 23(a)(1);

Economic Stabilization Agency General Order No. 15, 17 Fed. Reg. 2994;

U. S. Treasury Regulations 118, Sections 39.21-1 and 39.22(a)-5.

They are printed in Appendix B, *infra*, pp. 41-44.

STATEMENT OF THE CASE.

These cases are suits for refund of income tax claimed to have been illegally collected. The facts were stipulated in the court below (R. 15-26, 41-51), and are as follows:

Petitioners Charles Pedone and Sam Pedone (now deceased) were the equal partners in Pedone Lathing & Plastering Company during the calendar year 1952. This partnership was engaged in the building construction industry as a plastering contractor, which business consists of contracting to apply rough and finish coats of

plaster to the interior walls and ceilings of buildings. The partnership employed plasterers and building laborers to perform the service of making such applications of coats of rough and finish plaster to walls and ceilings in order to perform the partnership's contracts to do so. The partnership furnished such materials as were needed to perform these contracts. (R. 16, 42.)

In its partnership income tax return for the calendar year 1952, the partnership claimed $414,248.59 as its cost of goods sold, and there was included in this claimed cost of goods sold amounts paid by the partnership to the persons it had employed to perform the work it had contracted to perform. These employees were subject to the jurisdiction of the Economic Stabilization Agency and the Wage Stabilization Board of the aforementioned agency. (R. 17, 42-43.)

Prior to the promulgation of the Wage Stabilization Board's regulations, it had been the custom of Pedone Lathing and Plastering Company to pay its employees premium rates. During 1952 the partnership made certain wage payments to its employees in contravention of the Defense Production Act of 1950, as amended, and the orders and regulations promulgated thereunder. Upon request to do so, the partnership cooperated with the Wage Stabilization Board in cutting back to the legal area rate. (R. 22, 47.)

On or about November 25, 1952, the partners of Pedone Lathing & Plastering Company entered into a stipulation with the Wage Stabilization Board with respect to these wage payments. Pursuant to the stipulation, a Certificate of Disallowance was forwarded to the Commissioner of Internal Revenue, advising him that, for the purpose of calculating the deductions of Pedone Lathing & Plastering Company, the amount of $13,535.00 was to

be disregarded as an income tax deduction for the partnership's taxable year ending December 31, 1952, and was to be charged against the income of the partners, Sam and Charles Pedone, in proportion to their respective partnership interests. (R. 17-18, 11-12, 43, 50-51.)

In its partnership income tax return for 1952, the amounts paid by the partnership to its employees for performing the work which it had contracted to perform and claimed in the return as part of its cost of goods sold included the aforesaid $13,535.00. (R. 18, 43.)

Subsequently, the Commissioner of Internal Revenue assessed deficiencies against the respective petitioners, which deficiencies were determined by disallowing to the partnership as part of its cost of goods sold the $13,535.00. Petitioners paid the deficiencies, filed claims for refund, and thereafter filed these suits. (R. 18-19, 44.)

The jurisdiction of the Court of Claims was invoked because the cases arise under the internal revenue laws enacted by Congress. The actions were brought under the Internal Revenue Code of 1954, particularly Section 7422 thereof, and 28 U. S. C. Section 1491.

Three judges of the court decided that petitioners were not entitled to recover and dismissed the petitions. Two judges dissented, principally on the ground that the interpretation placed upon the Defense Production Act of 1950, as amended, by the majority rendered the pertinent provisions of the Act unconstitutional.

REASONS FOR GRANTING THE WRIT.

In the case of *Allen vs. Grand Central Aircraft Company*, 347 U. S. 535, 74 Sup. Ct. 745 (1954), this Court decided certain administrative questions arising under the Defense Production Act of 1950. In the course of its opinion this Court stated:

> "We have noted the other arguments submitted by appellee concerning the interpretation and constitutionality of the statute but it would be premature action on our part to rule upon these until after the required administrative proceedings have been exhausted." 347 U. S. 535 at 553.

All the required administrative proceedings have been exhausted in the instant cases, and one of the constitutional arguments raised by the appellee in the *Allen* case (347 U. S. 535 at 553, fn. 22(4)) is now presented squarely to the Court. This question is, in effect, composed of two elements: whether Section 405(b) of the Defense Production Act of 1950, as amended, abrogated the principle of the income tax laws requiring the tax-free return of capital to a taxpayer and thereby made the income tax a tax on gross receipts; and, if so, whether a tax on gross receipts contravenes the Sixteenth Amendment to the Constitution. These questions involve the fundamental bases of the income tax law, that is, the meaning of the Sixteenth Amendment and the extent of congressional power to legislate thereunder. These cases, therefore, present questions which are peculiarly appropriate for the exercise of this Court's discretionary jurisdiction.

The decision of the court below is erroneous in that, although the majority of the court admit that the Sixteenth Amendment does not authorize a tax upon gross receipts, they, in fact, sanction such a tax upon the ground of expediency. The dissenting opinion effectively demonstrates that expediency cannot override the Constitution:

> "It seems to me that the Constitution, the basic law of the land, is the framework for all public policy. The Congress apparently has the power to regulate wages but in so doing it cannot reduce or cut across the announced policy of the Constitution as it relates to

income taxation, that is, that only income, not capital, is subject to income taxation." (p. 28, *infra*.)

Furthermore, the provisions of the Defense Production Act of 1950 did not disallow the *offset* of wages against gross receipts as a return of capital in determining the amount of gross income, but disallowed only the *deduction* from gross income, in determining the amount of net or taxable income, of those wages which are not a part of cost of goods sold. The income tax is a tax on income, not on gross receipts. "Income" is gross receipts less the return of capital which this Court has decided the Sixteenth Amendment requires. Thus, the decision below, in interpreting the Act to disallow the return of capital, conflicts with applicable decisions of this Court in the leading income tax cases of *Eisner vs. Macomber*, 252 U. S. 189 (1920), and *Doyle vs. Mitchell Bros. Co.*, 247 U. S. 179 (1918), to the effect that the Sixteenth Amendment does not permit a tax on gross receipts. See also *Rutkin vs. United States*, 343 U. S. 130, 139 (1950).

The statement by the court below that the cost of the services sold by the partnership did not constitute a part of its cost of goods sold nullifies the decisions of this Court that gross receipts are not synonymous with income. The holding of the court below is, in effect, that a business which renders only services has *no* capital investment whatever. This is so extraordinary a holding and of such far-reaching consequence that it merits consideration by this Court.

In this regard it is to be noted that although the Commissioner of Internal Revenue recognizes in his Regulations (U. S. Treasury Regulations 118, Sections 39.21-1 and 39.22(a)-5) that there must be an allowance for return of capital, he has never defined what constitutes "capital." As a result, there is confusion among tax-

payers, and the Commissioner has taken grossly inconsistent and contradictory positions in litigation involving that question. The Commissioner takes that position which will produce the greater revenue in a particular case, even though his position in one case is the diametric opposite of his position in another case. This results in unfairness to taxpayers and in improper and contradictory administration of the revenue laws. Compare, for example, the Commissioner's position in *Ray Edenfield*, 19 T. C. 13 (1952), and *Woodside Acres, Inc. vs. Commissioner*, 134 F. 2d 793 (2d Cir. 1942), with his position in the court below in the instant cases. See also *Levine, Gross Income in the Personal Holding Company*, 9 Tax L. Rev. 453, 461 (1954). The instant cases involve important and fundamental questions of federal law that should be settled by this Court and not left to the inconsistent and contradictory interpretations of administrative agencies.

Furthermore, a decision by this Court upon the fundamental questions involved in these cases would go far in clarifying the nature and structure of the income tax and the extent of the powers of the federal government thereunder.

CONCLUSION.

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A.

Opinions, Findings and Judgment of the Court of Claims.

IN THE UNITED STATES COURT OF CLAIMS

(Decided May 8, 1957)

No. 39-55

ROSE PEDONE, EXECUTRIX OF THE ESTATE OF SAM PEDONE, AND ROSE PEDONE v. THE UNITED STATES.

No. 40-55

CHARLES PEDONE AND MARIAN PEDONE v. THE UNITED STATES.

Majority Opinion.

MADDEN, *Judge*, delivered the opinion of the court:

These actions are for the recovery of income taxes alleged to have been improperly assessed for the year 1952 against plaintiffs Sam and Rose Pedone, jointly as husband and wife, and against plaintiffs Charles and Marian Pedone, jointly as husband and wife, in the amounts of $2,756.64 and $2,797.64, respectively, plus interest. Since the actions were instituted, plaintiff Sam Pedone has died and his wife, Rose Pedone, has been substituted as executrix of his estate.

During the period in question, plaintiffs Sam and Charles Pedone, were equal partners in the Pedone Lathing & Plastering Company, whose business was primarily that of a plastering contractor. The operations of the business consisted of employing plasterers and laborers to apply rough and finish coats of plaster to the interior walls and ceilings of buildings. The materials necessary to do the jobs were also supplied by the partnership.

At all times herein pertinent, the above referred to employees were subject to the jurisdiction of the Economic Stabilization Agency and its Wage Stabilization Board, which were organized and operated pursuant to the Defense Production Act of 1950, 64 Stat. 798, 803-812, as amended, 50 U. S. C. App. §§ 2061, 2101-2110 (1952). The pertinent provisions of title IV of that act are as follows:

> Sec. 401. * * * Whenever the authority granted by this title is exercised, all agencies of the Government dealing with the subject matter of this title, within the limits of their authority and jurisdiction, shall cooperate in carrying out these purposes.
>
> * * * * *
>
> Sec. 405. * * * (b) No employer shall pay, and no employee shall receive any wage, salary, or other compensation in contravention of any regulation or order promulgated by the President under this title. *The President shall also prescribe the extent to which any wage, salary, or other compensation payment made in contravention of any such regulation or order shall be disregarded by the executive departments and other governmental agencies in determining the costs or expenses of any employer for the purposes of any other law or regulation.* (Emphasis supplied.)

Specific penalties for violation of the provisions of the act are provided for in section 409 thereof:

> Sec. 409. * * * (b) Any person who willfully violates any provision of section 405 of this title shall be guilty of a misdemeanor and shall, upon conviction thereof, be subject to a fine of not more than $10,000, or to imprisonment for not more than one year, or both. Whenever the President has reason to believe that any person is liable to punishment under this subsection, he may certify the facts to the Attorney

General, who may, in his discretion, cause appropriate proceedings to be brought.

(c) If any person selling any material or service violates a regulation or order prescribing a ceiling or ceilings, the person who buys such material or service for use or consumption other than in the course of trade or business may, within one year from the date of the occurrence of the violation, except as hereinafter provided, bring an action against the seller on account of the overcharge. In any action under this subsection, the seller shall be liable for reasonable attorney's fees and costs as determined by the court, plus whichever of the following sums is greater: (1) such amount not more than three times the amount of the overcharge, or the overcharges, upon which the action is based as the court in its discretion may determine, but in no event shall such amount exceed the amount of the overcharge, or the overcharges, plus $10,000, or (2) an amount not less than $25 nor more than $50 as the court in its discretion may determine: * * *

Sections 409 (a) and 706 of the act also provide for the availability of injunctions, restraining or other orders of a temporary or permanent nature, whenever any person has engaged or is about to engage in any act violative of section 405 or any other section of the act.

The Economic Stabilization Agency on April 3, 1952, issued its General Order No. 15, 17 Fed. Reg. 2994, effective April 5, 1952, dealing with policy and procedure with respect to disallowances for violation of title IV of the Defense Production Act, *supra*, and that order provides in part as follows:

Sec. 4. *Disallowance policy*—(a) *Purposes of disallowance.* The disallowances under the authority granted by sections 2 and 3 may be made for one or more of the purposes of:

(1) Calculating deductions or the basis for determining gain under the Revenue Laws of the United States;

(2) Determining costs and expenses under any contract made by or on behalf of the United States, either directly or indirectly; * * *

From March 1, 1952, through September 12, 1952, the partnership paid wages in excess of the maximum established pursuant to the authority granted by section 405 (b) of the Defense Production Act quoted above. The partnership's wage scales for journeyman plasterers ran from about $3.00 per hour to $3.50 per hour during the period when the approved area rate was only $2.97 per hour to $3.07 per hour. The partnership paid its laborers at rates varying from $2.125 per hour to $2.50 per hour when the approved area rate was $2.10 per hour to $2.35 per hour. The record shows that the plaintiffs cooperated with the Enforcement Division of the Wage Stabilization Board in cutting back to the legal area rate upon request to do so. The record also shows that it was the custom of the employer to pay premium rates since it began operations and that the employees had received raises proportionately since that date.

On or about November 25, 1952, the partners entered into a stipulation with the Wage Stabilization Board with respect to the excessive wage payments. That stipulation contained a provision that the parties agreed that the stipulation be transmitted to the National Enforcement Commission of the Economic Stabilization Agency for the issuance and transmittal of a Certificate of Disallowance to the appropriate executive departments or other agencies of the Government pursuant to section 405 (b) of the Defense Production Act, *supra*, and section 4 of the Economic Stabilization Agency's General Order No. 15, *supra*.

It also contained an agreement that the National Enforcement Commission could forthwith certify to the Commissioner of Internal Revenue that for the purpose of calculating deductions or the basis for determining gains of the employer under the revenue laws of the United States the sum of $13,535 should be disregarded for the employer's taxable year ending December 31, 1952, and that the deduction should be charged against the income of the partners, plaintiffs in these cases. On December 16, 1952, the National Enforcement Commission sent a Certificate of Disallowance to the Commissioner of Internal Revenue and advised him as hereinbefore noted.

In its partnership income return for 1952, the amount the partnership paid its employees for performing the work of plastering was included as part of the partnership's cost of goods sold and amounted to $257,720.72. This amount included the above $13,535.

The Commissioner of Internal Revenue, purportedly acting pursuant to the Defense Production Act, Economic Stabilization Agency General Order No. 15, and the Certificate of Disallowance, disallowed the inclusion of the $13,535 as part of the partnership's cost of goods sold and assessed a deficiency against the respective taxpayers in an amount that such an exclusion would reflect.

On or about November 4, 1953, plaintiffs filed a claim for refund in the amounts specified above as the sum sought to be refunded by this suit. Six months expired without any action by the Commissioner, and the plaintiffs brought this suit.

The plaintiffs say that the Government, in refusing to subtract the wages actually, though illegally, paid, from the amounts received by the plaintiffs from their plastering contracts, is taxing them, not upon their income, but

upon their gross receipts. They make an argument which is not easy to follow, that the services for which the wages were paid were the "goods sold" by them, and that, therefore, the wages were the costs of the goods sold and must be subtracted from the price received in order to determine the income or profit from the contracts. If it were material it should be pointed out that the plaintiffs were not selling services. They were selling finished jobs of plastering, not essentially different from finished books or storm doors. Materials and labor are necessary to produce any of these things, and the materials, improved and increased in value by the labor, are the things to which title passes.

But we think that these refinements of the law of title to property have nothing to do with our problem. There is no doubt that in the ordinary case the wages of the persons who work on the product sold are subtractable from the sale price, in determining taxable income. Whether that subtraction is made in this column or that column, or this schedule or that schedule, of the income tax form, does not, in the normal case, affect the amount of the tax. The rare case in which it does make a difference where the labor costs are placed in the income tax form is illustrated by *Woodside Acres, Inc.*, 46 BTA 1124, 134 F. 2d 793 (C. A. 2). But the question of the order of computation on the tax form, a question of the interpretation and application of the taxing statutes, is not important in relation to the constitutional question of whether certain receipts may be subjected to a Federal income tax at all.

It was not the intent of the 16th amendment to authorize the Federal Government to lay an income tax upon everything of value that came into the ownership of the potential taxpayer. The common understanding of

the word income is the amount which one has gained by his transaction or activity. His gains, not his gross receipts, are his constitutionally taxable income. Our question is whether the line of constitutional taxability is so sharply drawn that Congress has not the power, in order to promote some public policy, to provide that certain costs, the incurring of which is in violation of law or public policy, shall be disregarded in computing gains, *i.e.*, taxable income. If Congress may so provide, the "gain" which is taxed is, one must admit, a fictitious one. If interested parties promise to pay a legislative representative $50,000 to secure the enactment of certain legislation, and if the representative spends $25,000 to bribe legislators in order to obtain or better insure the enactment of the legislation, is it constitutional to tax as income the $50,000, or only the $25,000 which the representative has left after he had spent the other $25,000 for bribes? See Supreme Court discussion in *Lilly et al v. Commissioner*, 343 U. S. 90.

Since as early as the Revenue Act of 1918, in sections 214 (a) (1) and 234 (a) (1)[1] Congress has limited the amount which may be subtracted for income tax purposes, on account of salaries and labor, from the selling price of goods, to a "reasonable allowance" for salaries and wages. The Commissioner of Internal Revenue has, when necessary, reduced the amounts, particularly of executive salaries, to what he regarded as reasonable amounts in the circumstances. If the plaintiff's contention is correct, this provision in the successive statutes has been unconstitutional. We do not think that such a constitutional infirmity has existed for all these decades without being discovered

[1]See 26 U. S. C. (1952 ed., Supp. II) 162 (a) (1) for the corresponding provision in the Internal Revenue Code of 1954.

and exposed in litigation. Common opinion, and acquiescence by those affected by legislation over a long period is evidence of a community sense that its Government has not exceeded its lawful powers.

If the 16th amendment gives the Government leeway to refuse to treat as a subtractable cost of goods sold a perfectly lawful wage or salary actually paid, because the Government rightfully concludes that it is unreasonably large, it would seem that, *a fortiori*, the Government could accord similar treatment to payments made in violation of law or public policy. If it could not do so, it would find itself in the position of subsidizing the violation of its law or public policy, since a percentage of the improper payment, depending on the tax bracket of the taxpayer, would be recovered by him in the form of a reduction of his income tax. In this type of cases, as in the cases of unreasonable wages and salaries, we understand that the practice of refusing to allow the subtraction of such expenditures is almost as old as the income tax law.

Upon this background of history and common opinion we are not willing to impose the revolutionary doctrine which the plaintiff urges upon us. Our conclusion is that the plaintiffs did not overpay their taxes, and their petitions must be dismissed.

It is so ordered.

WHITAKER, *Judge*; and JONES, *Chief Judge*, concur.

Dissenting Opinion.

LARAMORE, *Judge*, dissenting:

I respectfully dissent from the opinion of the majority in this case for what I think are some very cogent reasons.

Plaintiffs concede that they made wage payments in excess of maximums established pursuant to section 405

(b), but argue that the value of the services rendered by the aforementioned employees are, because of their nature, elements of the cost of goods sold and, therefore, constitutionally exempt from taxation. They contend that to permit an income tax on these wages would be to tax capital, and since the 16th amendment to the Constitution permits income taxation only on "income" the tax would be unconstitutional. Plaintiffs argue that the provision "income" in the 16th amendment does not mean gross receipts and that the term, by its very nature, permits an exclusion from the gross receipts of the cost of the goods sold before arriving at the income taxable under the 16th amendment. The cost of the goods sold, it is argued, is capital. The goods sold in plaintiffs' cases were services, they argue, thus, when the partnership is paid in money for the value of the services rendered, the payment represents merely a return of the capital expenditure for wages. Therefore, plaintiffs continue, to the extent that receipts embrace a repayment of the capital expenditure, that is, to the extent that the receipts are reimbursement for the cost of goods sold, they are constitutionally exempt from taxation, hence, the Commissioner of Internal Revenue cannot exclude the value of such services in determining the income subject to taxation, despite the Defense Production Act or General Order No. 15 of the Economic Stabilization Agency which were the basis of the Commissioner's actions in these cases. Taxpayers argue, however, that there is no authority in the act or the order to empower the Commissioner to disallow the wages in question as the act speaks only of "expenses" and the order of "deductions," both of which are words of art which have a carefully defined meaning under the Internal Revenue Code. Plaintiffs contend that the Defense Production Act and the order by the use of those terms provide only for the dis-

allowance of the deduction of expenses which are normally deductible under section 23 of the Internal Revenue Code, but that Congress did not intend to disallow the offset against gross receipts for cost of goods sold as it was without the authority to do so; the cost of goods sold being a constitutionally exempt item.

Plaintiffs further argue that to the extent that the Defense Production Act permits the interpretation placed upon it by the Commissioner of Internal Revenue it is unconstitutional.

Defendant, on the other hand, feels that section 407 (b) of the Defense Production Act, *supra*, authorizes the Commissioner of Internal Revenue to disregard any amount in arriving at taxable income upon receipt of a

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[1] Section 23 of the Internal Revenue Code of 1939 follows:

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. In the case of any sports program conducted for the benefit of the American National Red Cross, expenses described in section 22 (b) (16) (B) shall be allowable under this subparagraph only to the extent that such expenses exceed the amount excluded from gross income by section 22 (b) (16).

Section 23 continues from subsection (b) through subsection (ff) (4) and relates to other items not covered in the above paragraph but which the code specifically denominates as deductible in arriving at taxable income under the code.

Section 24 deals with items specifically not deductible.

Certificate of Disallowance. In arguing that the Commissioner's actions in subtracting the subject amount in determining taxable income was correct despite the fact that the sum may properly have been an element of the plaintiffs cost of goods sold, defendant says that the fallacy of taxpayers' argument is that Congress intended to control all wages paid by any employer covered by the act, not just wages which are not included as part of the cost of goods sold. Defendant argues also that the word "costs" in section 405 (b) of the act indicates the congressional intent to cover all items including labor costs which are part of the cost of goods sold. Defendant asserts that a tax on the excluded amount would not constitute a tax on capital as plaintiff contends, because capital is broadly that which they, plaintiffs, invested in their business as their contribution to the partnership and later net profits which had been allowed to accumulate.

Defendant further argues that to support plaintiffs' contentions would frustrate the intent of the act to regulate wages; however, in this respect plaintiffs point to other sections of the act which provide criminal and civil sanctions, the purposes of which are to enforce the act.

As to the word "costs" in section 405 (b) plaintiffs argue that it has reference to costs or expenses under any contract made by or on behalf of the United States or for the purpose of laws other than the revenue laws and that section 4 (a) (2) of the Economic Stabilization Agency's General Order No. 15 supports this view.

Despite the argument of the defendant and the feeling of the majority of this court, I believe I should point out the fallacy of the argument that Congress intended to cover all wages even if part of the cost of goods sold; to wit, if, as plaintiffs contend, the subject amount of wages

is constitutionally exempt from taxation, then it matters not that Congress, by the Defense Production Act, intended that overpayments of such wages should be excluded in determining taxable income because, in such a case, it would be without Congress' jurisdiction to do so. Congress certainly has the power to regulate wages of all kinds by any means available to it, but, if constitutional provisions exempt an item from taxation, the mere fact that the payment of that item represents the violation of a statute does not empower the Congress to levy a tax upon it. The Constitution is supreme and Congress cannot act except in accordance with it.

By the same reasoning, if plaintiff's argument is correct, and defendant's is also correct to the extent that the word "costs" contained in section 405 (b) was intended by the Congress to mean or refer to the cost of goods sold, then Congress' action by the use of the term in trying to regulate the cost of goods sold was improper and, hence, ineffectual and unconstitutional.

Thus, as I see it, the issues in this case are whether the cost of goods sold may be subject to income taxation in light of the 16th amendment and, if not, are the wages in question paid by the plaintiffs to their employees charged with doing the plastering work truly an element of the cost of goods sold of the partnership. If the first question can be answered in the negative and the second in the affirmative, plaintiffs can recover, otherwise they must fail.

I am of the opinion that the cost of goods sold is constitutionally exempt from taxation and that the wages here in question are truly an element of the cost of goods sold.

The basis of the present income tax laws is the 16th amendment to the Constitution which provides as follows:

> The Congress shall have power to lay and collect taxes on *incomes*, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration. [Emphasis supplied.]

While, over the years, there has been some dispute as to whether the term "income" contained therein means "gross income" or "net income," the cases are quite settled on the point that it does not mean "gross receipts."

> * * * In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration. *Doyle v. Mitchell Brothers Co.*, 247 U. S. 179, 185.

On this subject Mertens, *Law of Federal Income Taxation*, volume 1, section 5.10, and the cases cited therein, are quite explanatory:

> The history of the income tax in this country from its crude beginning as a war-time measure in 1861 to the present day, shows a development of the idea that such a tax should be imposed upon *net* income. The Sixteenth Amendment does not, however, define income and does not specify whether the tax is to be imposed upon net income or gross income. Although under our present statutory scheme the tax is imposed essentially upon net incomes, the question whether such a tax may be imposed upon gross income is not academic; it arises in the allowance or disallowance of statutory deductions, and particularly in determining whether taxable income must allow for exhaustion of the asset producing the receipts, that is, whether such receipts include a return of capital.
>
> It is now generally agreed that the income tax is not limited to "net income" but may under certain circumstances be imposed upon gross income. The

courts have repeatedly viewed deductions as matters of legislative grace, so that "net income" becomes a statutory rather than an economic concept under which items which might be considered as gross income by the business man are treated as taxable income by statute.

*To say that items of gross income may be taxed is not the same as to say that under all circumstances the courts will countenance a tax on gross receipts. The terms "gross income" and "gross receipts" are not synonymous. "Gross receipts" is a broader term, including within it receipts which may constitute capital as well as income, and, * * * returns of capital may not be taxed.* [Citations omitted and emphasis supplied.]

Section 5.06 of the cited volume states, at page 171, as follows:

While there has been and still is considerable groping in determining when increment in capital has been realized so as to be taxable, *there is substantial agreement that amounts received as a return of capital or investment are not income within the general meaning of that term and may not be taxed under the Sixteenth Amendment.* [Citations omitted and emphasis supplied.]

This view has also been expounded by Roswell Magill in his work *Taxable Income,* and cases therein cited, at page 359 wherein he states:

This line of decisions, from *Doyle v. Mitchell Bros. Co.* down to date, indicates that the term "income" does not mean total gross receipts from the sale of property. Although the decisions are expressly worded in terms of statutory construction, some of them actually go beyond that, since under the specific terms of the act considered in *Goodrich v. Edwards,* for example, there would have been a taxable profit, whereas the Court held that no gain or income was

realized. This requirement that the capital investment must be returned before the proceeds become taxable as income results from the somewhat sharp distinction, at least in this regard, between income and capital. It would seem clear to the ordinary person that only the gain over the original cost is income. The Court has adopted the same view. *Hence, the cost of goods sold must be allowed as a deduction from gross receipts in arriving at the income which is subject to tax under the amendment and the revenue laws.* [Citations omitted and emphasis supplied.]

I am in agreement with the above quotations and feel quite emphatically that "gross receipts" cannot be designated as the "income" specified in the 16th amendment subject to income taxation. "Income" in both its generic and technical sense connotes some gain.

Therefore, income tax, pursuant to the 16th amendment, can be assessed only on "income" and not on "gross receipts." The term gross receipts embodies within it that expenditure of capital that was spent for the product sold. Before there can be income, that expenditure of capital must be recovered. After it has been recovered, then, and only then, is there income which may be subject to taxation under the 16th amendment.

There seems little doubt that this is the proper construction of the 16th amendment. Congress itself apparently recognized the limitations placed upon it by the amendment as the revenue laws since 1918 have consistently used "gross income" as the starting point of all income taxation and the courts have interpreted it as meaning just that and not "gross receipts." See *Lela Sullenger et al. v. Commissioner*, 11 T. C. 1076, 1077; *Ray Edenfield v. Commissioner*, 19 T. C. 13, 22; *Joe W. Scales et ux. v. Commissioner*, 18 T. C. 1263, 1276; *Commissioner*

v. Weisman, 197 F. 2d 221, 224. Section 22 of the Internal Revenue Code of 1939 is indicative of this use of the term "gross income." Congress has not attempted to levy an income tax on gross receipts since the ratification of the 16th amendment by the states.

Thus, I believe that the true cost of goods sold cannot, under the present state of the Constitution, be subject to income taxation since items properly falling within that category represent capital and not income, and are constitutionally exempt from taxation. However, merely because an item of expense has been placed in that category by the accountant does not mean that it is rightly there. The courts must determine whether or not the item is truly a cost of the product sold. Such is a question of fact and must be determined with reference to the peculiar facts of the case then under consideration.

In the plaintiffs' cases the product allegedly sold was the services of its employees. If that is so, the cost to plaintiffs of the rendition of those services would represent an expenditure of capital on their part and would have to be recovered before any income tax could be assessed pursuant to the constitutional amendment.

It is well settled that labor costs, as such, may, depending on the nature of the labor, be an element of the cost of goods sold. *United Carbon Co. v. Commissioner*, 32 B. T. A. 1000, reversed on other grounds, 90 F. 2d 43 (4th Cir. 1937); *Woodside Acres Inc. v. Commissioner*, 46 B. T. A. 1124, *aff'd* 134 F. 2d 793, (2d Cir. 1934); *Ray Edenfield v. Commissioner*, *supra*. The court in *Woodside Acres* stated as follows at page 1129:

> * * * Expenditures included in the cost of production of the milk certainly include the cost of feed for the cows and the wages of the men who took care of the animals and milked them. The milk then had to

be separated from the cream and had to be pasteurized. The butter had to be churned. The wages of the men who put the product through these processes are properly a part of the cost of production.

The Tax Court has also held that wages in a construction business where the primary product sold is the services of its employees are actually a part of the cost of goods sold, *Ray Edenfield v. Commissioner, supra*. In that case, it was the Commissioner of Internal Revenue who argued that the labor of an electrical contracting business was properly an element of the cost of goods sold. The Commissioner's argument was sustained by the decision of the Tax Court with the following language at page 22:

> Petitioner claims $758,004.18 gross income was reported from his business of Edenfield Electric Co. Of course, if he is correct as to that, then clearly section 275 (c) does not have any application. But it seems to us that petitioner confuses gross receipts with gross income and obviously the two are not the same. The expenses in question constitute a part of the cost of operations of the Edenfield Electric Co. and, as such, these expenses are to be deducted from gross receipts in arriving at gross income. The Internal Revenue Code authorizes no deduction for cost of goods sold or cost of operation but such costs must be deducted in arriving at gross income.

In that case the Government stood to gain by the inclusion of the labor in the cost of goods sold because the issue there was whether the taxpayer had omitted on his return 25 percent of his gross income so as to bring into effect the 5-year statute of limitations, thereby lifting the bar of the 3-year statute. The taxpayer claimed that the wages he paid were not part of his cost of goods sold and that only his materials were. With the inclusion of labor as part of the cost of goods sold it reduced taxpayer's

gross income to an amount, which when added to other income, made the amount reported less than 25 percent of the true gross income and thereby brought into operation the 5-year statute of limitations against plaintiff. The Government's argument and the Tax Court decision in that case seem to indicate that the Government and the Tax Court recognize that labor costs of the nature in question in the instant suit; that is, labor costs of a construction business where the primary product sold is services, are truly a part of the cost of goods sold of the business.

While these cases establish that certain wages may be properly included as part of the cost of goods sold and, also, that an item properly includible in the cost of goods sold should be accorded tax treatment consistent with that terminology, they do not involve the question of whether wages paid in excess of ceilings prescribed pursuant to statute can be excluded therefrom by the Commissioner of Internal Revenue when that statute gives the President the authority to certify to the various governmental departments the extent to which that department should disallow the amount of the overpayment in determining the costs and expenses of the violator. However, it seems quite clear, based on what I have said above, that if the wages in question are truly an element of the cost of goods sold they cannot be excluded therefrom by the Commissioner of Internal Revenue despite the Stabilization Act; indeed, even the Congress cannot exclude them from the cost of goods sold if they are truly an element thereof. Moreover, any revenue act that attempts to reach the actual cost of goods sold and deny its inclusion in arriving at gross income is unconstitutional. The Constitution is supreme and all else subordinate thereto. However, I do not think the Defense Production Act of 1950 is unconstitutional. I simply say that a construction cannot be

placed upon that act that would attempt to tax a constitutionally exempt item. Section 401 of the 1950 act states that "all agencies dealing with the subject matter of this title, *within the limits of their authority and jurisdiction*, shall cooperate in carrying out these purposes." Thus, it can be seen that Congress had no intention of attempting to give the Commissioner of Internal Revenue a power he did not otherwise have. The act specifically said he could act only within the limits of his authority, and his authority was limited by the Constitution which allows him to assess income tax on income only, not on capital.

It is my opinion that *all* the wages paid by plaintiffs to those employees charged with the duty of doing the plastering work are truly part of the partnership's cost of goods sold and on no theory can such labor be excluded from the cost of goods sold. They are constitutionally exempt from taxation. To tax them would be to levy an income tax on capital and not on income.

Further, it is my opinion that the excessive wage payments of $13,535 here in question are also truly part of the cost of goods sold; hence, the Commissioner of Internal Revenue does not have the authority to exclude them from those costs in arriving at taxable income notwithstanding the Defense Production Act. This is not to say that in a situation involving wages which are not a part of the cost of goods sold but otherwise deductible as ordinary and necessary business expenses under section 23 of the 1939 Internal Revenue Code the Commissioner would not have the power to exclude excessive payments as deductions in arriving at taxable income when he received a Certificate of Disallowance. He would clearly have the authority to do so in such a case as it was given him by section 405 (b) of the Defense Production Act.

I feel that there is no element of unconstitutionality in section 405 (b) and that "costs and expenses" therein used and "deductions" used in the Economic Stabilization Agency General Order No. 15 relate, insofar as the Internal Revenue Code is concerned, only to those items properly deductible or excludible under the code. Since such deductions or exclusions are matters of legislative grace, they can be taken away by Congress as well.

I think it would be appropriate to note that my views here do not tend in any way to defeat the purpose of the act which was, *inter alia*, to prevent inflation by holding wages to certain prescribed maximums, nor do they tend to put the Government in the position "of subsidizing the violation of its law or public policy," as the majority suggests, since sections 409 and 706 of the act provide civil and criminal penalties which are sufficiently adequate to insure substantial compliance. Among other things, those sections make a violator of the law subject to a $10,000 fine and imprisonment for one year. Also, I do not feel that a decision as suggested by this opinion would frustrate any law or public policy as the majority believes it would. It seems to me that the Constitution, the basic law of the land, is the framework for all public policy. The Congress apparently has the power to regulate wages but in so doing it cannot reduce or cut across the announced policy of the Constitution as it relates to income taxation, that is, that only income, not capital, is subject to income taxation.

I think the plaintiffs are entitled to a judgment for the entire amount claimed, plus interest as provided by law.

[LITTLETON, *Judge*, joins in the foregoing dissent.]

Findings of Fact.

The court makes findings of fact, based on the stipulation of the parties, the briefs, and argument of counsel as follows:

No. 39-55.

1. Sam Pedone and Rose Pedone were husband and wife at all times herein pertinent. Sam Pedone died on May 26, 1955. On June 27, 1955, Rose Pedone was appointed executrix of his estate by the Probate Court of Cuyahoga County, Ohio, and is still serving and acting in such capacity. During his lifetime, Sam Pedone and Rose Pedone resided at 17032 Scottsdale Avenue, Cleveland, Ohio.

2. A joint federal income tax return on form 1040 for the calendar year 1952 was filed by Sam Pedone and Rose Pedone with the district director at Cleveland, Ohio, on March 16, 1953. Plaintiffs paid the tax reported on the said form 1040 for 1952 on the dates and in the amounts as follows:

Date	*Amount*
April 10, 1952	$1,000.00
July 1, 1952	1,000.00
September 22, 1952	1,000.00
January 26, 1953	1,300.00
March 27, 1953	2,018.68

3. During the calendar year 1952, decedent, Sam Pedone, was one of the partners in Pedone Lathing & Plastering Company and during said year owned a 50-percent interest therein. Said partnership was engaged in the building construction industry as a plastering contractor. Said business consists of contracting to apply rough and finish coats of plaster to the interior walls and

ceilings of buildings. Said partnership employed plasterers and building laborers to perform the service of making such applications of coats of rough and finish plaster to such walls and ceilings in order to perform said partnership's contracts to do so. The partnership furnished such materials as were needed to perform these contracts.

4. In its partnership income return for the calendar year 1952, said partnership claimed $414,248.59 as its cost of goods sold, and there was included in said claimed cost of goods sold the amounts paid by said partnership to the persons it had employed to perform the work contracted for in the amount of $257,720.72. At all times herein pertinent, such employees were subject to the jurisdiction of the Economic Stabilization Agency which was created pursuant to the Defense Production Act of 1950, 64 Stat. 798, 803-812, as amended, 50 U. S. C. App. § 2061, 2101-2110 (1952), and the Wage Stabilization Board of the aforementioned agency.

5. The applicable portions of the Defense Production Act of 1950, *supra*, are as follows:

> Sec. 401 * * * Whenever the authority granted by this title is exercised, all agencies of the Government dealing with the subject matter of this title, within the limits of their authority and jurisdiction, shall cooperate in carrying out these purposes.
>
> * * * * * *
>
> Sec. 405. * * * (b) No employer shall pay, and no employee shall receive any wage, salary, or other compensation in contravention of any regulation or order promulgated by the President under this title. The President shall also prescribe the extent to which any wage, salary, or other compensation payment made in contravention of any such regulation or order shall be disregarded by the executive departments and other governmental agencies in determin-

ing the costs or expenses of any employer for the purposes of any other law or regulation.

Sections 409 and 706 of the act provide for the penalties to be exacted against violators.

6. The Economic Stabilization Agency on April 3, 1952, issued its General Order No. 15, 17 Fed. Reg. 2994, effective April 5, 1952, dealing with policy and procedure with respect to disallowances for violation of title IV of the Defense Production Act, *supra*, and that order provides in part as follows:

> Sec. 4. *Disallowance policy*—(a) *Purposes of disallowance.* The disallowances under the authority granted by sections 2 and 3 may be made for one or more of the purposes of:
>
> (1) Calculating deductions or the basis for determining gain under the Revenue Laws of the United States;
>
> (2) Determining costs and expenses under any contract made by or on behalf of the United States, either directly or indirectly; * * *

7. During the calendar year 1952, the partnership made wage payments to its employees in contravention of the Defense Production Act of 1950, *supra*, and the orders and regulations promulgated thereunder as follows:

During the period from March 1, 1952, to September 12, 1952, the partnership paid its journeyman plasterers employed on the site of construction in Cuyahoga County, Ohio, at the rate of $3.00 per hour to $3.50 per hour, during which period the Construction Industry Stabilization Commission approved area rate in Cuyahoga County was $2.97 per hour from March 1, 1952, to the next full payroll period beginning on or after May 19, 1952, when an area rate of $3.075 per hour was established and approved.

These area rates were approved by the Construction Industry Stabilization Commission in Case No. C—4887, issued April 8, 1952, and Case No. C—6148, issued June 2, 1952, respectively.

During the period from March 1, 1952, to September 12, 1952, the partnership paid building laborers employed on the site of construction in Cuyahoga County, Ohio, at the rate of $2.125 per hour to $2.50 per hour, during which period the Construction Industry Stabilization Commission approved area rate in Cuyahoga County was $2.10 per hour from March 1, 1952, to the next full payroll period beginning on or after June 18, 1952, when an area rate of $2.325 per hour was established and approved.

8. $61,665.00 is the approximate total amount of wages, salaries, and other compensation paid in contravention and $3,500 is the approximate amount of wages, salaries, and other compensation paid in excess of the amount allowable to said employees from March 1, 1952, to September 12, 1952, when the employer came into compliance with the Defense Production Act, *supra*, and the orders and regulations promulgated thereunder.

9. There were extenuating and mitigating circumstances which justified the disallowance of only $13,535 instead of $61,665. Those extenuating and mitigating circumstances are as follows:

(a) The partnership cooperated with the Enforcement Division of the Wage Stabilization Board in cutting back to the legal area rate upon request to do so.

(b) It has been the custom of the partnership to pay premium rates since operations began and the employees' wages have been raised proportionately since then.

10. On or about November 25, 1952, the partners, including decedent, Sam Pedone, of Pedone Lathing &

Plastering Company, entered into a stipulation with the Wage Stabilization Board in Case No. 61-EL/E—3666 with respect to said wage payments.

That stipulation contained a provision that the parties agreed that the stipulation be transmitted to the National Enforcement Commission of the Economic Stabilization Agency for the issuance and transmittal of a Certificate of Disallowance to the appropriate executive departments or other agencies of the Government pursuant to section 405(b) of the Defense Production Act, *supra*, and section 4 of the Economic Stabilization Agency's General Order No. 15, *supra*. The stipulation also contained an agreement that the National Enforcement Commission could forthwith certify to the Commissioner of Internal Revenue that for the purpose of calculating deductions or the basis for determining gains of the partnership under the revenue laws of the United States, the sum of $13,535 should be disregarded for the year ending December 31, 1952, and that the deduction should be charged against the income of the partners for that year.

11. A Certificate of Disallowance, dated December 16, 1952, was forwarded to the Commissioner of Internal Revenue, advising him that, for the purpose of calculating the deductions of Pedone Lathing & Plastering Company, the amount of $13,535 was to be disregarded as deduction for said partnership's taxable year ending December 31, 1952, and was to be charged against the income of the partners, including decedent, Sam Pedone, in proportion to their respective partnership interests. With respect to decedent, Sam Pedone, the apportioned amount of disallowance was $6,767.50.

12. In its partnership income return for the calendar year 1952, the amounts paid by said partnership to its said

employees for performing the work which it had contracted for was claimed in said return as part of its cost of goods sold and amounted to $257,720.72. This amount included the aforesaid $13,535.

13. On or about September 24, 1953, the Commissioner of Internal Revenue assessed a deficiency against Sam Pedone and Rose Pedone in the amount of $1,474.28 plus interest. Said deficiency was determined by adjusting the inventory of said Pedone Lathing & Plastering Company (which adjustment is not here in issue) and by disallowing to said partnership as part of its cost of goods sold the said $13,535. The inventory adjustment decreased and the latter adjustment increased decedent's distributive share of income from said partnership and the tax thereon as reported in his said joint return for the year 1952. Said deficiency was paid on or about August 9, 1954.

14. On or about November 4, 1953, Sam Pedone and Rose Pedone filed a claim for refund of income tax paid for 1952 in the amount of $2,756.64 or such greater amount as is legally refundable. On or about November 5, 1954, Sam Pedone and Rose Pedone duly and timely amended their claim for refund. The Commissioner of Internal Revenue did not render a decision thereon within six months after the date of filing said original claim. This suit was filed after the expiration of said six months.

No. 40-55.

1. Plaintiffs, husband and wife, reside at 19605 Marvin Avenue, Warrensville Heights, Ohio.

2. A joint Federal income tax return on form 1040 for the calendar year 1952 was filed by plaintiffs with the district director at Cleveland, Ohio, on March 16, 1953.

Plaintiffs paid the tax reported on the said form 1040 for 1952 on the dates and in the amounts as follows:

Date	*Amount*
April 15, 1952	$1,000.00
July 1, 1952	1,000.00
September 22, 1952	1,000.00
January 26, 1953	1,300.00
March 16, 1953	2,190.92

3. During the calendar year 1952, plaintiff Charles Pedone was one of the partners in Pedone Lathing & Plastering Company and during said year owned a 50-percent interest therein. Said partnership was engaged in the building construction industry as a plastering contractor. Said business consists of contracting to apply rough and finish coats of plaster to the interior walls and ceilings of buildings. Said partnership employed plasterers and building laborers to perform the service of making such applications of coats of rough and finish plaster to such walls and ceilings in order to perform said partnership's contracts. The partnership furnished such materials as were needed to perform these contracts.

4. In its partnership income return for the calendar year 1952, said partnership claimed $414,248.59 as its cost of goods sold, and there was included in said claimed cost of goods sold the amounts paid by said partnership to the persons it had employed to perform the work contracted for in the amount of $257,720.72. At all times herein pertinent, such employees were subject to the jurisdiction of the Economic Stabilization Agency which was created pursuant to the Defense Production Act of 1950, 64 Stat. 798, 803-812, as amended, 50 U. S. C. App. § 2061, 2101-2110 (1952), and the Wage Stabilization Board of the aforementioned agency.

5. The applicable portions of the Defense Production Act of 1950, *supra*, are as follows:

> Sec. 401. * * * Whenever the authority granted by this title is exercised, all agencies of the Government dealing with the subject matter of this title, within the limits of their authority and jurisdiction, shall cooperate in carrying out these purposes.
>
> * * * * *
>
> Sec. 405. * * * (b) No employer shall pay, and no employee shall receive any wage, salary, or other compensation in contravention of any regulation or order promulgated by the President under this title. The President shall also prescribe the extent to which any wage, salary, or other compensation payment made in contravention of any such regulation or order shall be disregarded by the executive departments and other governmental agencies in determining the costs or expenses of any employer for the purposes of any other law or regulation.

Sections 409 and 706 of the act provide for the penalties to be exacted against violators.

6. The Economic Stabilization Agency on April 3, 1952, issued its General Order No. 15, 17 Fed. Reg. 2994, effective April 5, 1952, dealing with policy and procedure with respect to disallowances for violation of title IV of the Defense Production Act, *supra*, and that order provides in part as follows:

> Sec. 4. *Disallowance policy*—(a) *Purposes of disallowance.* The disallowances under the authority granted by sections 2 and 3 may be made for one or more of the purposes of:
>
> (1) Calculating deductions or the basis for determining gain under the Revenue Laws of the United States;

(2) Determining costs and expenses under any contract made by or on behalf of the United States, either directly or indirectly; * * *

7. During the calendar year 1952, the partnership made wage payments to its employees in contravention of the Defense Production Act of 1950, *supra*, and the orders and regulations promulgated thereunder as follows:

During the period from March 1, 1952, to September 12, 1952, the partnership paid its journeyman plasterers employed on the site of construction in Cuyahoga County, Ohio, at the rate of $3 per hour to $3.50 per hour, during which period the Construction Industry Stabilization Commission approved area rate in Cuyahoga County was $2.97 per hour from March 1, 1952, to the next full payroll period beginning on or after May 19, 1952, when an area rate of $3.075 per hour was established and approved. These area rates were approved by the Construction Industry Stabilization Commission in Case No. C-4887, issued April 8, 1952, and Case No. C-6148, issued June 2, 1952, respectively.

During the period from March 1, 1952, to September 12, 1952, the partnership paid building laborers employed on the site of construction in Cuyahoga County, Ohio, at the rate of $2.125 per hour to $2.50 per hour, during which period the Construction Industry Stabilization Commission approved area rate in Cuyahoga County was $2.10 per hour from March 1, 1952, to the next full payroll period beginning on or after June 18, 1952, when an area rate of $2.325 per hour was established and approved.

8. $61,665 is the approximate total amount of wages, salaries, and other compensation paid in contravention, and $3,500 is the approximate amount of wages, salaries, and other compensation paid in excess of the amount al-

lowable to said employees from March 1, 1952, to September 12, 1952, when the employer came into compliance with the Defense Production Act and the orders and regulations promulgated thereunder.

9. There were extenuating and mitigating circumstances which justified the disallowance of only $13,535 instead of $61,665. Those extenuating and mitigating circumstances are as follows:

(a) The partnership cooperated with the Enforcement Division of the Wage Stabilization Board in cutting back to the legal area rate upon request to do so.

(b) It had been the custom of the partnership to pay premium rates since operations began and the employees' wages have been raised proportionately since that date.

10. On or about November 25, 1952, the partners, including plaintiff Charles Pedone, of Pedone Lathing & Plastering Company, entered into a stipulation with the Wage Stabilization Board in Case No. 61—EL/E—3666 with respect to said wage payments.

That stipulation contained a provision that the parties agreed that the stipulation be transmitted to the National Enforcement Commission of the Economic Stabilization Agency for the issuance and transmittal of a Certificate of Disallowance to the appropriate executive departments or other agencies of the Government pursuant to section 405(b) of the Defense Production Act, *supra*, and section 4 of the Economic Stabilization Agency's General Order No. 15, *supra*. The stipulation also contained an agreement that the National Enforcement Commission could forthwith certify to the Commissioner of Internal Revenue that for the purpose of calculating deductions or the basis for determining gains of the partnership under the revenue laws of the United States, the sum of $13,535 should

be disregarded for the year ending December 31, 1952, and that the deduction should be charged against the income of the partners for that year.

11. A Certificate of Disallowance, dated December 16, 1952, was forwarded to the Commissioner of Internal Revenue, advising him that, for the purpose of calculating the deductions of Pedone Lathing & Plastering Company, the amount of $13,535 was to be disregarded as deduction for said partnership's taxable year ending December 31, 1952, and was to be charged against the income of the partners, including plaintiff Charles Pedone, in proportion to their respective partnership interests. With respect to plaintiff Charles Pedone, the apportioned amount of disallowance was $6,767.50.

12. In its partnership income return for the calendar year 1952, the amounts paid by said partnership to its said employees for performing the work which it had contracted for was claimed in said return as part of its cost of goods sold and amounted to $257,720.72. This amount included the aforesaid $13,535.

13. On or about September 24, 1953, the Commissioner of Internal Revenue assessed a deficiency against plaintiffs in the amount of $1,498.88 plus interest. Said deficiency was determined by adjusting the inventory of said Pedone Lathing & Plastering Company (which adjustment is not here in issue) and by disallowing to said partnership as part of its cost of goods sold the said $13,535. The inventory adjustment decreased and the latter adjustment increased plaintiff Charles Pedone's distributive share of income from said partnership and the tax thereon as reported in his said joint return for the year 1952. Said deficiency was paid on or about August 9, 1954.

14. On or about November 4, 1953, plaintiffs duly and timely filed a claim for refund of income tax paid for 1952 in the amount of $2,797.64 or such greater amount as is legally refundable. On or about November 5, 1954, plaintiffs duly amended their claim for refund. The Commissioner of Internal Revenue did not render a decision thereon within six months after the date of filing said original claim. This suit was filed after the expiration of said six months.

Conclusion of Law.

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that the plaintiffs are not entitled to recover, and their petitions are dismissed.

APPENDIX B.

CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS INVOLVED.

United States Constitution, Sixteenth Amendment:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

United States Constitution, Article I, Section 9, in part:

"No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

Defense Production Act of 1950, 64 Stat. 798, as amended, in part:

SEC. 401: ". . . Whenever the authority granted by this title is exercised, all agencies of the Government dealing with the subject matter of this title, within the limits of their authority and jurisdiction, shall cooperate in carrying out these purposes." Title IV, 64 Stat. 803; 50 U. S. C. App. Section 2101.

SEC. 405: "(b) No employer shall pay, and no employee shall receive, any wage, salary, or other compensation in contravention of any regulation or order promulgated by the President under this title. The President shall also prescribe the extent to which any wage, salary, or compensation payment made in contravention of any such regulation or order shall be disregarded by the executive departments and other governmental agencies in determining the costs or expenses of any employer for the purposes of any other law or regulation." Title IV, 64 Stat. 807, 65 Stat. 136; 50 U. S. C. App. Section 2105(b).

SEC. 409: "(a) Whenever in the judgment of the President any person has engaged or is about to engage in any acts or practices which constitute or will constitute a violation of any provision of section 405 of this title, he may make application to any district court of the United

States or any United States court of any Territory or other place subject to the jurisdiction of the United States for an order enjoining such acts or practices, or for an order enforcing compliance with such provision, and upon a showing by the President that such person has engaged or is about to engage in any such acts or practices a permanent or temporary injunction, restraining order, or other order, with or without such injunction or restraining order, shall be granted without bond.

"(b) Any person who willfully violates any provision of section 405 of this title shall be guilty of a misdemeanor and shall, upon conviction thereof, be subject to a fine of not more than $10,000, or to imprisonment for not more than one year, or both. . . ." Title IV, 64 Stat. 811, 65 Stat. 136; 50 U. S. C. App. Section 2109.

SEC. 706: "(a) Whenever in the judgment of the President any person has engaged or is about to engage in any acts or practices which constitute or will constitute a violation of any provision of this Act, he may make application to the appropriate court for an order enjoining such acts or practices, or for an order enforcing compliance with such provision, and upon a showing by the President that such person has engaged or is about to engage in any such acts or practices a permanent or temporary injunction, restraining order, or other order, with or without such injunction or restraining order, shall be granted without bond." Title VII, 64 Stat. 817, 65 Stat. 139; 50 U. S. C. App. Section 2156(a).

Internal Revenue Code of 1939, in part:

SEC. 22. *Gross Income.*

"(a) 'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or

interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever." 26 U. S. C. 1952 ed., Section 22(a).

SEC. 23. *Deductions from Gross Income.*

"In computing net income there shall be allowed as deductions:

(a) Expenses—

(1) Trade or Business Expenses—

(A) In General—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; . . ."

26 U. S. C. 1952 ed., Section 23(a)(1).

The Economic Stabilization Agency, General Order No. 15, 17 Fed. Reg. 2994 (April 3, 1952), in part:

"Sec. 4. *Disallowance policy*—(a) *Purposes of disallowance.* The disallowances under the authority granted by sections 2 and 3 may be made for one or more of the purposes of:

(1) Calculating deductions or the basis for determining gain under the Revenue Laws of the United States;

(2) Determining costs and expenses under any contract made by or on behalf of the United States, either directly or indirectly; . . ."

U. S. Treasury Regulations 118, in part:

"SEC. 39.21-1. Meaning of net income.

"(a) The tax imposed by chapter 1 is upon income. Neither income exempted by statute or fundamental law, nor expenses incurred in connection therewith, other than

interest, enter into the computation of net income as defined by section 21. (See section 24(a)(5).) In the computation of the tax various classes of income must be considered:

"(1) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. . . .

"(2) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by chapter 1. (See section 22.)

"(3) Net income, meaning gross income less statutory deductions. . . ."

"Sec. 39.22(a)-5. Gross income from business.

"In the case of a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. . . ."

In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 265.

ROSE PEDONE,
Executrix of the Estate of Sam Pedone,
and
ROSE PEDONE,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

CHARLES PEDONE and MARIAN PEDONE,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF CLAIMS

REPLY BRIEF FOR PETITIONERS.

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THE GATES LEGAL PRINTING CO., CLEVELAND, OHIO, MAY 1, 1958

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ARGUMENT.

Petitioners contend that in using the words "expenses" and "deductions" in the Defense Production Act of 1950, as amended, and the regulations thereunder, Congress and the Economic Stabilization Agency were employing words of art which have a carefully defined meaning under the Internal Revenue Code. The Act provides for

the disallowance of the deduction of expenses which are normally deductible under Section 23 of the Internal Revenue Code of 1939, but Congress did not intend to disallow the offset against gross receipts for cost of goods sold. The word "costs" in Section 405(b) of the Act has reference to costs or expenses under any contract made by or on behalf of the United States or for the purpose of laws other than the revenue laws—references which are inapplicable here. See Economic Stabilization Agency Order 15, 17 Fed. Reg. 2994; Wage Stabilization Board Release No. 41, June 13, 1951.

Furthermore, petitioners recognize that Congress intended to control all wages paid by employers covered by the Act. Petitioners' position does not thwart or limit this Congressional intent. Congress employed various means by which to carry out this control. Sections 409 and 706 of the Act provide for injunctive action, treble damage suits, and criminal punishment for any violation of Section 405. These means of enforcement apply to all overpayments of wages, regardless of whether they constitute part of an employer's cost of goods sold; any wage overpayment could be stopped or penalized through the use of any of these sanctions. Section 405(b) merely added an additional sanction applicable only to wage overpayments, and the limitation of such a sanction to wages which are not a part of cost of goods sold obviously does not contradict or defeat the Congressional intent.

The Weather-Seal Manufacturing Co., 16 T. C. 1312 (1951), affd. 199 F. 2d 376 (6th Cir. 1952), is different from the instant cases. *Weather-Seal* involved wages paid to employees who *produced* the storm windows and doors sold by Weather-Seal. In the instant cases, the services of Pedone Lathing & Plastering Company's plasterers were the very goods sold, and the amounts paid to them con-

stitute its cost of goods sold. The Tax Court recognized implicitly in *Weather-Seal* that receipts which in fact represent a return of capital are not taxable as income.

The case of *Harold Binder*, P-H 1953 T. C. Mem. Dec. ¶ 53,183, merely followed the *Weather-Seal* decision without discussion. Since it also involved the production of goods as distinguished from services, it is similarly different from the instant cases. *Gilmore v. U. S.*, 131 Fed. Supp. 581 (D. C. Calif. 1955), also followed *Weather-Seal* without any discussion of the reasons therefor.

The case of *N. A. Woodworth Company v. Kavanaugh*, 102 Fed. Supp. 9 (D. C. Mich.), affd. 202 F. 2d 154 (6th Cir. 1953), does not reject petitioners' argument. The only constitutional argument raised in that case was whether the Wage Stabilization Act of 1942 was unconstitutional as providing for an excessive fine and cruel and unusual punishment contrary to the Eighth Amendment to the Constitution. The basis of unconstitutionality raised by petitioners here was not raised or decided in that case. The cases of *Solon Decorating Company*, P-H 1957 T. C. Mem. Dec. ¶ 57,035, and *Sidney Zehman*, 27 T. C. No. 107 (1957), both involve the identical issue involved here. Both cases were filed by the attorneys representing petitioners here, and the appeals from the decisions of the Tax Court in those cases to the Court of Appeals for the Sixth Circuit have been held in abeyance by stipulation of the parties and order of the Court pending this Court's disposal of the instant cases.

The Government contends (Br. 8-11) that Congress has the power to levy a tax under the Sixteenth Amendment on the gross receipts derived from a business without the apportionment required by Article I, Section 9 of the Constitution, or to put it another way, that Congress has

the power to tax a return of a taxpayer's capital investment to him without apportionment. This contention has been rejected by many cases and by leading writers on federal taxation. See, for example, *Winkler v. United States*, 230 F. 2d 766 (1st Cir. 1956); *Commissioner v. Weisman*, 197 F. 2d 221 (1st Cir. 1952); *Hamilton National Bank v. District of Columbia*, 156 F. 2d 843 (D. C. Cir. 1946); *Lela Sullenger*, 11 T. C. 1076 (1948); *1 Mertens, Law of Federal Income Taxation* Sec. 5.06 (Rev. ed. 1956); *Magill, Taxable Income* 359 (Rev. ed. 1945). This contention was denied also by *all* of the judges of the court below in deciding the instant cases, majority as well as minority. (Pet. 15, 21). If there is any validity to the Government's contention, which runs contrary to such a multitude of decisions and opinion, it should be for this Court to make such a determination.

The adoption of the Sixteenth Amendment overcame the holding of *Pollock v. Farmers' Loan & Trust Company*, 157 U. S. 429, 15 Sup. Ct. 673 (1895), that whether a tax is direct is to be determined by viewing the burden on the property from which the income is derived. The Sixteenth Amendment, however, did not overrule the holding of *Pollock* that a tax on property is a direct tax that must be apportioned. *Brushaber v. Union Pacific Railroad Co.*, 240 U. S. 1, 36 Sup. Ct. 236 (1916). A tax on gross receipts which include the return of capital is not the tax on income authorized by the Sixteenth Amendment, but is, in effect, a tax on property itself. A tax on capital must be apportioned or, under the *Pollock* case, it is unconstitutional.

Furthermore, the Government's contention conflicts with applicable decisions of this Court in *Burnet v. Logan*, 283 U. S. 404, 51 Sup. Ct. 550 (1931); *Merchants' Loan & Trust Company v. Smietanka*, 255 U. S. 509, 41 Sup. Ct. 386 (1921); *Eisner v. Macomber*, 252 U. S. 189, 40 Sup. Ct.

189 (1920); and *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 38 Sup. Ct. 467 (1918).

Many lower courts have interpreted the cases of this Court to mean that Congress must allow for a return of capital under the Sixteenth Amendment. Whether all of these lower courts have misinterpreted this Court's decisions, and we think that they have not, involves an important question of federal law which should be settled by this Court—a question involving consequences of obvious importance to both Congress and taxpayers.

There is a further fallacy in the Government's position even if we assume, for the sake of argument, that Congress did intend to disallow the offset of cost of goods sold against gross receipts and that Congress constitutionally may make such disallowance, i.e., may tax gross receipts. Congress also said in Section 405(b) of the Defense Production Act of 1950 that this offset "* * * shall be disregarded * * * for the purposes of *any other law or regulation*" (italics ours). The "other law" involved here is the Internal Revenue Code of 1939, which levies a tax only on income. The plain fact is that *there is no law levying a tax on gross receipts.* Therefore, the argument that Congress may tax gross receipts is inapplicable and irrelevant. The other laws involved here levy a tax on income, not on gross receipts.

The starting point of all income taxation is gross income under Section 22(a). Gross income, however, is not synonymous with gross receipts. Gross income, the Regulations state, means "the total sales less the cost of goods sold." Regs. 118, Sec. 39.22(a)-5. Certainly there is no confusion in the decisions of this Court to the effect that gross income is not synonymous with gross receipts. As stated in *Doyle v. Mitchell Bros. Co.*, 38 Sup. Ct. 467, 469 (1918):

"* * * By the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities * * *.

"* * * In order to determine whether there has been gain or loss, and the amount of the gain if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

See also *1 Mertens, Law of Federal Income Taxation*, Sec. 5.06 at page 171 (Rev. ed. 1956).

In *Commissioner v. Weisman*, 197 F. 2d 221, 224 (1st Cir. 1952), the court was careful to point out that there is no tax on gross receipts:

"The Commissioner argues that the distinction between deductions and cost of goods is lacking in significance, is tenuous and diminishes tax liability unless the distinction is wiped out or disregarded. We disagree with this contention for we believe there is a real distinction between offsets, such as cost of goods under § 22 and deductions under § 23. It is not a difference without substance and has more support for its existence than being merely an historical accident. The return of capital is guaranteed by the 'cost of goods' offset against gross receipts and thus is avoided the charge that it is a tax on capital and not on income * * *. The tax under consideration is not a tax on gross receipts."

Therefore, the Defense Production Act of 1950 does not provide for the disallowance of the offset for cost

of goods sold, since the only law involved here to which its provisions could possibly refer is a law which taxes income but not gross receipts.

CONCLUSION.

The Government argues that Congress may constitutionally disallow the return of capital to a taxpayer and thereby tax his gross receipts. This argument is contrary to court decisions. Furthermore, the argument is irrelevant since the tax laws provide for no tax on gross receipts but only on income. These questions, specifically reserved by this Court in *Allen v. Grand Central Aircraft Company*, 347 U. S. 535, 74 Sup. Ct. 745 (1954), (Pet. 5-6) are ones of basic, fundamental importance and are peculiarly appropriate for the exercise of this Court's discretionary jurisdiction.

For the foregoing reasons and for the reasons set forth in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted,

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No. 265

In the Supreme Court of the United States

OCTOBER TERM, 1957

ROSE PEDONE, EXECUTRIX OF THE ESTATE OF SAM PEDONE, ROSE PEDONE, CHARLES PEDONE, and MARIAN PEDONE, PETITIONERS

v.

THE UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (R. 53-68; Pet. 9-28) is not yet reported.

JURISDICTION

The judgment of the Court of Claims was entered May 8, 1957 (R. 53, 77; Pet. 9, 40). The petition for a writ of certiorari was filed on July 12, 1957. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255(1).

QUESTIONS PRESENTED

1. Did the Court of Claims err in holding that wage payments made by the taxpayers' partnership to its employees, in violation of the wage stabilization pro-

visions of the Defense Production Act of 1950, were not deductible, as the cost of goods sold or as expenses, in computing income subject to tax?

2. Did Congress exceed its constitutional authority in providing that wage payments made in violation of the wage stabilization provisions of the Defense Production Act of 1950 should be disregarded as cost or expense in computing income under the revenue laws?

STATUTES AND OTHER AUTHORITIES INVOLVED

The relevant portions of the Constitution of the United States, the Defense Production Act of 1950 (Section 405), the Internal Revenue Code of 1939 (Sections 22(a), and 23(a)(1)(A)), Treasury Regulations 118 (Section 39.22(a)-5), and General Order No. 15 of the Economic Stabilization Agency, are set forth in the Appendix, *infra*, pp. 12-15.

STATEMENT

The facts, which are undisputed, are set forth in the stipulation of facts (R. 15-26, 41-51) and in the findings of fact entered by the Court of Claims (R. 69-77; Pet. 29-40). They may be summarized as follows:

During the calendar year 1952, taxpayers[1] were equal partners in Pedone Lathing and Plastering Company, which was engaged in the building construction industry as a plastering contractor. It contracted to apply rough and finish coats of plaster to the interior walls and ceilings of buildings, and employed plasterers and building laborers who applied the coats of

[1] For convenience, Sam Pedone and Charles Pedone will be referred to in this brief as the taxpayers. Sam Pedone is now deceased and his widow is his duly appointed executrix. Rose and Marian Pedone are parties to this suit because they filed joint income tax returns with their husbands.

plaster in the performance of these contracts. The partnership furnished the materials needed to perform these contracts (Pet. 29-30, 35).

In the partnership's return of income for 1952, it claimed $414,248.59 as the cost of goods sold, which sum included amounts paid to persons employed to perform the plastering contracts (Pet. 30, 35). During this period, these employees were subject to the jurisdiction of the Economic Stabilization Agency and the Wage Stabilization Board established under the Defense Production Act of 1950, as amended (Pet. 30-31, 35-37). During 1952, the partnership made payments of wages to its employees in contravention of the Defense Production Act and of the orders and regulations promulgated thereunder, in the approximate total amount of $61,665 (Pet. 31-32, 37-38). However, the partnership had cooperated with the Enforcement Division of the Wage Stabilization Board in cutting back to the legal area rate upon request, and it had been the custom of the partnership to pay premium rates from the time it began operations and the employees' wages had been raised proportionately since then; these were considered mitigating circumstances justifying the disallowance of only $13,535, instead of $61,665 (Pet. 32, 38).

On November 25, 1952, the partnership entered into a stipulation with the Wage Stabilization Board for the issuance of a Certificate of Disallowance agreeing, among other things, to the transmittal of the stipulation to the National Enforcement Commission of the Economic Stabilization Agency, and, without further notice or proceeding, to the issuance and transmittal by this Commission of a Certificate of Disallowance to the Commissioner of Internal Revenue certifying that

for the purpose of calculating deductions or the basis for determining gains of the employer the sum of $13,535 should be disregarded for the partnership's taxable year 1952, the deduction to be charged against the income of the partners (Pet. 32-33, 38-39).

A Certificate of Disallowance was issued and transmitted to the Commissioner of Internal Revenue by the National Enforcement Commission, providing in part as follows (Pet. 33, 39; R. 50-51):

> For the purpose of calculating the deductions of the partnership in its federal income tax information return, the sum of $13,535.00 shall be disregarded for the partnership's taxable year ending December 31, 1952, and said deduction shall be charged therein against the income of the partners, Sam Pedone and Charles Pedone, respectively, from the said partnership for the said taxable year in the proportion of their respective partnership interests, which are as follows: Sam Pedone 50%; Charles Pedone 50%. . .

Taxpayers nevertheless included in their partnership return for 1952 the full amounts paid the employees, including the $13,535. The Commissioner thereupon reduced the partnership's cost of goods sold by $13,535, increased the taxpayers' distributable share of partnership net income, and assessed deficiencies, which were paid on August 9, 1954. Pet. 33-34, 39). Taxpayers filed original and amended claims for refund on November 4 and 5, 1953, respectively, and filed suits for refund after the expiration of six months, no action on the claims for refund having been taken by the Commissioner (Pet. 34, 40). The Court of Claims con-

cluded that the taxpayers were not entitled to recover, and dismissed their petition (Pet. 40).

ARGUMENT

The decision below sustains the Commissioner's assessment of deficiencies against the taxpayers for 1952 resulting from a reduction of the partnership cost of goods sold by $13,535, the stipulated amount of illegal wage payments made in contravention of the Defense Production Act of 1950, and the regulations issued thereunder. Taxpayers attack the Commissioner's action on statutory and constitutional grounds, but their challenges are wholly without substance.

1. Recognizing the need to curb inflationary tendencies during the Korean hostilities, Congress provided for the regulation of wage and salary payments in the Defense Production Act of 1950, thus continuing the policies in effect during World War II under the Emergency Price Control Act of 1942, c. 26, 56 Stat. 23. Section 405(b) of the Defense Production Act of 1950, Appendix, *infra*, pp. 12-13, prohibited an employer from paying, or an employee from receiving, any compensation in contravention of regulations promulgated under the Act, and provided that—

> The President shall also prescribe the extent to which any wage, salary, or compensation payment made in contravention of any such regulation or order shall be disregarded by the executive departments and other governmental agencies in determining *the costs or expenses of any employer for the purposes of any other law or regulation.* [Emphasis added.]

General Order No. 15 of the Economic Stabilization Agency[2] (17 Fed. Reg. 2994, Appendix, *infra*, p. 15) established the policy of disallowing these illegal wage payments in "Calculating deductions or the basis for determining gain under the Revenue Laws of the United States." See also I. T. 4105, 1952-2 Cum. Bull. 93.

Taxpayers appear to urge (Pet. 7-8) that Section 405 (b) of the Defense Production Act, *supra*, is inapplicable to their case because it relates, insofar as income taxation is concerned, only to illegal wages claimed as deductions under Internal Revenue Code Section 23(a)(1)(A), Appendix, *infra*, p. 14, as ordinary and necessary expenses of the business (but not part of the cost of goods sold), and not at all to illegal wages claimed to be part of the partnership's capital costs which, it is said, must be recovered before any income tax may be imposed. But, as the Court of Claims pointed out, under the explicit provisions of the statute and the regulations the right of the Government is clear to reduce the amount of the cost of goods sold by the amount of the payments made in violation of law. Congress did not limit the scope of the Defense Production Act to deductions which are not part of the cost of goods sold, but made broad general reference to "costs or expenses," whether a part of the goods sold or otherwise. Wages paid in contravention of the Act and the regulations were thus declared as a matter of law to constitute unreasonable compensation and to be disre-

[2] Executive Order 10161 (15 Fed. Reg. 6105) created the Economic Stabilization Agency and provided that the functions conferred on the President by Title IV of the Defense Production Act were delegated to the Administrator of the Agency.

garded in computing taxable income. Congress established the rigid criterion that, as a matter of public policy, such payments should not be allowed as an expense of doing business. To ignore that criterion would result in the direct frustration of the underlying public policy of the Act, and, as the Court of Claims pointed out, would permit a taxpayer to benefit by the improper payment through a reduction in his income tax. See *Lilly* v. *Commissioner*, 343 U.S. 90.

The result should not depend upon whether the taxpayer itemizes the illegal wages as an expense representing compensation paid to employees, or whether, as in this case, it includes the wages in its cost of goods sold. In both instances, net income would be reduced, and it is clear that items included in the cost of goods sold may be questioned in arriving at net income. See *American Pitch Pine Export Co.* v. *Commissioner*, 188 F. 2d 721 (C.A. 5th); *Majestic Securities Corp.* v. *Commissioner*, 120 F. 2d 12 (C.A. 8th).

Taxpayer's argument has been rejected, in effect, by the Sixth Circuit in *Weather-Seal Manufacturing Co.* v. *Commissioner*, 199 F. 2d 376, affirming, *per curiam*, 16 T.C. 1312. See also *Solon Decorating Co.* v. *Commissioner*, decided February 28, 1957 (1957 P-H T. C. Memorandum Decisions, par. 57,035); and *Zehman* v. *Commissioner*, 27 T.C. No. 107, both pending on appeal in the Sixth Circuit. See also *Gilmore* v. *United States*, 131 F. Supp. 581 (N.D. Calif.); *N. A. Woodworth Co.* v. *Kavanagh*, 102 F. Supp. 9 (E.D. Mich.), affirmed, *per curiam*, 202 F. 2d 154 (C.A. 6th); and *Binder* v. *Commissioner*, decided May 27, 1953 (1953 P-H T.C. Memorandum Decisions, par. 53,183). The *Weather-Seal Manufacturing Co.* case, *supra*, spe-

cifically held that, regardless of whether the illegal wage payments were reported on the taxpayer's return as part of the cost of goods sold or otherwise as a deduction from gross income, wages constitute compensation for personal services rendered and, under Code Section 23(a)(1)(A), Appendix, *infra*, p. 14, they are deductible from gross income only if reasonable and lawful in amount.

Such cases as *Commissioner* v. *Weisman*, 197 F. 2d 221 (C.A. 1st), and *Sullenger* v. *Commissioner*, 11 T.C. 1076,[3] relied on by the dissenting opinion below (Pet. 23-24), and *Woodside Acres* v. *Commissioner*, 134 F. 2d 793 (C.A. 2d), relied on by the taxpayers (Pet. 8), are clearly not in point. In *Weisman*, the First Circuit expressly distinguished a situation involving illegal wage payments specifically forbidden by the Defense Production Act of 1950 from one which involved the inclusion in the cost of goods sold of payments for materials (in the taxable year 1944) in excess of lawful ceiling prices—an action which was then not illegal. The *Woodside Acres* case did not involve the allowance of a tax deduction, as here, but rather the determination of the amount of gross income of a dairy farm for the purpose of ascertaining statutory percentages which would, in turn, decide the question whether or not the taxpayer corporation was a personal holding company.

2. Taxpayers also erroneously argue (Pet. 6) that, if the Defense Production Act of 1950 is interpreted to disallow part of the partnership's cost of goods sold, the Act is unconstitutional as countenancing a tax not

[3] See also *Jones* v. *Herber*, 198 F. 2d 544 (C.A. 10th); and *Hofferbert* v. *Anderson Oldsmobile Co.*, 197 F. 2d 504 (C.A. 4th).

levied on income within the meaning of the Sixteenth Amendment.

In the first place, there appears to be no constitutional reason why Congress could not impose a tax on gross receipts derived from a business, regardless of the meaning of the Sixteenth Amendment. The power to "lay and collect Taxes" granted to Congress by Article I, Section 8, Clause 1 of the Constitution, is a plenary one, limited only by the requirement that indirect taxes be uniform throughout the United States and by the requirement of Section 2, Clause 3, and Section 9, Clause 4 of Article I (Appendix, *infra*, p. 12) that capitation and other direct taxes should be apportioned among the states in accordance with their enumerated populations. The tax on the income of the taxpayers derived from the contracting business in which they were engaged does not offend the apportionment requirement since it was not a direct tax on property or the income from property. The power of Congress to tax business income without apportionment has long been recognized. *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433; *Nicol* v. *Ames*, 173 U.S. 509; *Spreckels Sugar Refining Co.* v. *McClain*, 192 U.S. 397; *Stratton's Independence* v. *Howbert*, 231 U.S. 399.

Thus it seems that no constitutional objection would exist even if the tax in question could be considered as being on gross receipts, for Congress could levy such a tax as an incidence of its original grant of power under the Constitution. The erroneous notion advanced by the taxpayers (Pet. 6) that the Sixteenth Amendment was a limitation on the power to tax was specifically rejected in *Brushaber* v. *Union Pacific R. R.*, 240 U.S. 1, 11, 17-18, and *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103, 112-113.

Secondly, it is clear that these particular taxpayers are not even being taxed on the gross receipts of their partnership. For the taxable year 1952, the partnership was permitted to deduct from its gross receipts all but $13,535 out of total wage payments of $257,720.72, included in a total reported cost of goods sold of $414,248.59 (Pet. 30-33; R. 69, 70.) Taxpayers were even permitted to deduct illegal wage payments of $48,130, for, due to extenuating and mitigating circumstances, the Commissioner disallowed only $13,535 out of the total illegal wage payment of $61,665. (Pet. 32-34; R. 71.)

Thirdly, Section 405(b) of the Defense Production Act of 1950 is clearly valid under the Sixteenth Amendment. The constitutional term "incomes" has no such rigid and fixed meaning—economic or legal—that it prohibits Congress from declaring that certain unlawful or improper "costs" or "expenses" shall not be considered in computing taxable income, even though such "costs" and "expenses" may actually have been incurred. Cf. *Textile Mills Corp.* v. *Commissioner*, 314 U.S. 326; *Commissioner* v. *Heininger*, 320 U.S. 467, 473-474; *Lilly* v. *Commissioner*, 343 U.S. 90, 94-95, 97; *United States* v. *Sullivan*, 274 U.S. 259, 264. The Commissioner has long had the right to limit the amount of a taxpayer's expenses of doing business to a *reasonable* allowance for wages and salaries, even where such payments were fully legal. (Code Section 23(a)(1)(A), and corresponding sections of prior Revenue Acts, starting with Sections 214(a)(1) and 234(a)(1), Revenue Act of 1918, c. 18, 40 Stat. 1057.) This provision of the revenue statutes is plainly beyond constitutional challenge. The same principle applies to wage payments which are *illegal* and specifi-

cally directed by Congress and valid regulations to be disregarded.[4]

CONCLUSION

The decision below is correct and involves no conflict of decisions or questions requiring review by this Court. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY, 1957.

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[4] The case of *Doyle* v. *Mitchell Bros. Co.*, 247 U.S. 179, on which taxpayers rely (Pet. 7), did not involve any constitutional concepts or the meaning of the Sixteenth Amendment. Nor is there anything in *Eisner* v. *Macomber*, 252 U.S. 189 (Pet. 7) which is helpful to the taxpayers' position here.

APPENDIX

Constitution of the United States:

ARTICLE I

SEC. 2. * * *

Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers. * * *.

* * * * *

Section 8. The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

* * * * *

Section 9. * * *

No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

* * * * * *

SIXTEENTH AMENDMENT

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Defense Production Act of 1950, c. 932, 64 Stat. 798:

Sec. 405 [as amended by Section 104(i), Defense Production Act Amendments of 1951, c. 275,

65 Stat. 131] (a) It shall be unlawful, regardless of any obligation heretofore or hereafter entered into, for any person to sell or deliver, or in the regular course of business or trade to buy or receive, any material or service, or otherwise to do or omit to do any act, in violation of this title or of any regulation, order, or requirement issued thereunder, or to offer, solicit, attempt or agree to do any of the foregoing. The President shall also prescribe the extent to which any payment made, either in money or property, by any person in violation of any such regulation, order, or requirement shall be disregarded by the executive departments and other governmental agencies in determining the costs or expenses of any such person for the purposes of any other law or regulation, including bases in determining gain for tax purposes.

(b) No employer shall pay, and no employee shall receive, any wage, salary, or other compensation in contravention of any regulation or order promulgated by the President under this title. The President shall also prescribe the extent to which any wage, salary, or compensation payment made in contravention of any such regulation or order shall be disregarded by the executive departments and other governmental agencies in determining the costs or expenses of any employer for the purposes of any other law or regulation.

(50 U.S.C. 1952 ed., Sec. 2105.)

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service,

of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, * * * or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.22(a)-5. GROSS INCOME FROM BUSINESS. In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside

operations or sources. In determining gross income, subtractions should not be made for depletion allowances based on discovery value or percentage of income, selling expenses, or losses, or for other items not ordinarily used in computing cost of goods sold. * * *

General Order 15 of the Economic Stabilization Agency, dated April 3, 1952 (17 Fed. Register 2994, 2995):

SEC. 4. *Disallowance policy.*—(a) *Purposes of disallowance.* The disallowances under the authority granted by sections 2 and 3 may be made for one or more of the purposes of:

(1) Calculating deductions or the basis for determining gain under the Revenue Laws of the United States;

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